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SUBJECT: SOUTH AFRICA'S 2006 BUDGET

11. Summary. Finance Minister Trevor Manuel outlined South Africa's planned expenditures and revenues over the next three years in the Budget 2006. Few finance ministers have the luxury of dispensing an unplanned \$6.9 billion in revenue, and having close to a balanced budget. Strong growth and improved tax collection improved South Africa's fiscal balances enough to give lower and middle income individuals and more small businesses tax relief, as well as modest increases in social grants aimed at the poor. Key to achieving government's goal of accelerated growth is increased spending on infrastructure and education, along with increased investment. Reaction to the Budget was mostly positive, with the major complaint coming from big business, which did not receive any tax cuts. End Summary.

After Climbing Mountains, Come Joys

12. Finance Minister Trevor Manuel opened his February 15 2006 Budget address to Parliament with the theme, "there are no joys without mountains having been climbed," a phrase borrowed from Nigerian poet Ben Okri. Manuel touted South Africa's GDP growth to be 5% in 2005 (Note: 2005 growth officially came in at 4.9%. End Note.) and in the years ahead, noting in Zulu that "this is the year of plenty, when all South Africans will reap the fruits of economic growth." Manuel highlighted South Africa's accomplishments and plans for the future, stating that since 1994, 3.5 million households have been given electricity, water is accessible to 90% of the population, and sanitation services are improving. He also said that housing subsidies will provide for 500,000 houses over the next three years and that 1,500 new jobs are now created each working day. In terms of challenges facing South Africa, Manuel underlined investment in infrastructure and skills development as the two most important.

A River of Revenue

13. Strong economic growth and improved tax collection meant the government collected R41.2 billion (\$6.9 billion) more revenue in the 2005/06 fiscal year (ending on March 31), than it had estimated in the February 2005 budget. Manuel proposed using the extra tax revenues to provide personal tax relief, reduce budget deficits, and increase spending on infrastructure and social grants. He announced R19.1 billion (\$3.2 billion) in tax relief to primarily middle to lower income brackets (those earning less than R250,000 or \$42,000). Additionally, he proposed plans to reduce

projected deficits to an average of 1.4% over the next three years, compared to previous planned deficits of over 2%, as well as to spend an additional R15 billion (\$2.5 billion) on increased infrastructure and social grants.

¶4. In fiscal year 2005/06, South Africa's budget is nearly balanced, as its strong economy and improved tax collection gave South Africa its lowest budget deficit in 25 years. Manuel announced that the National Treasury's estimated 2005/06 budget deficit is now 0.5% of GDP compared to an October 2005 estimate of 1% and a February 2005 estimate of 3.1%. If this estimate holds, it would be the lowest budget deficit since 1981's deficit/GDP of 0.4%. Manuel also forecasts smaller deficit/GDP ratios for each of the next three years even as the SAG increases its expenditure growth. He estimated South Africa's budget deficit at 1.5% of GDP in fiscal 2006/07, easing slightly to 1.4% in 2007/08 and reaching 1.2% 2008/09. These revised estimates compare to previous forecasts of 2.2% of GDP in fiscal 2006/07, 2.1% in 2007/08 and 2% in 2008/09, made last February. Manuel also lowered its forecast for public sector borrowing to 0.6% of GDP in fiscal 2005/06 and an average of 2.4 percent over the next three years.

Personal Tax Relief -----

¶5. Manuel announced tax cuts for individuals, small businesses and retirement savings. Personal taxes were cut by R13.5 billion (\$2.3 billion) with 73% of the reductions focused on individuals earning R250,000 (\$42,000) or less. The top tax bracket at which the 40% marginal rate applies will increase to R400,000 (\$67,000) from R300,000 (\$50,000),

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while the tax threshold at which employees begin paying tax increases to R40,000 (\$6,700) from R35,000 (\$5,800), beginning in April.

¶6. Manuel proposed reducing the tax on retirement savings by half to 9% starting March 1 in order to boost South Africa's low savings rate. In addition, taxes on property were reduced with the lower limit of property value being subject to taxes increased to R500,000 (\$83,000) compared to the previous threshold of R190,000 (\$32,000). Since 1996, there has been more than R80 billion (\$13 billion) in personal income tax reductions, mainly aimed at lower and middle income groups.

Small Firms Benefit in Corporate Tax Proposals -----

¶7. Manuel increased the pool of firms eligible for small business loans. Small businesses are now defined as having annual revenues of R14 million (\$2.3 million) or less compared to last year's revenue cap of R6 million (\$1 million). Manuel also announced that the income threshold for the lower 10% corporate tax rate would increase to R300,000 (\$50,000) from R250,000 (\$42,000) in 2005. Industry analysts had expected Manuel to reduce the top corporate tax rate, currently at 29%, or the secondary tax on companies, at 12.5%, but neither happened. The regional services council (RSC) taxes, payable to municipalities, were abolished amounting to a tax reduction of R7 billion (\$1.2 billion). Manuel made no announcement on whether there would be a replacement tax. The minister also raised thresholds for capital gains tax to account for inflation.

Only Sin Taxes and Road Fund Levies Increased -----

¶8. Manuel did increase taxes on alcohol, tobacco, and fuel. The tax increases on alcohol and tobacco will increase between 9% and 20% and between 5% and 10%, respectively. A 5 rand cent per liter increase in the Road Accident Fund charge will increase the prices of gasoline and diesel. The

overall tax burden averages 26.5% of GDP, higher than the previous government commitment of 25%.

Expenditure Plans

¶9. Spending on social services remains the key priority over the next three years, accounting for 53% of total spending in 2006/07 and increasing 12% per year. Manuel announced increased social security grants of R80.6 billion (\$13 billion). Disability and old age grants will rise to R820 (\$137) per month, an increase of R40. The foster care grant will be R590 (\$98) per month, an increase of R30. Finally, the child support grant (reaching children up to the age of 14) increased by R10 to reach R190 (\$32) per month. Manuel also announced an additional R34 billion (\$5.7 billion) for planned infrastructure spending over the 2006-2009 Medium Term Expenditure Framework. Expansions in the commuter rail network, water and road infrastructure will increase infrastructure spending sharply as South Africa prepares for the 2010 World Cup and implements the Accelerated and Shared Growth Initiative.

¶10. All government expenditures during 2005/06 fiscal year increased by 13.7%, higher than the 12.9% planned in the February 2005 National Budget and the 12.8% increase posited in October 2005 Mid Term Budget Policy Statement. In 2006/07, expenditure should increase 12.8% with an annual average of 10.9% over the next three years. As a percentage of GDP, expenditures will increase from 26.9% in 2005/06 to 27.6% for the next year and easing to 27.3% by 2008/09.

Exchange Controls Eased

¶11. Manuel announced another easing of foreign exchange restrictions on individuals. Individuals may now transfer up to R2 million (\$330,000) offshore a year, up from the previous limit of R750,000 (\$125,000). To promote investment in other African countries, companies will no longer have to own a majority stake in a foreign firm to invest elsewhere on the continent. The present foreign direct investment threshold of 50% will be lowered to 25%

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for investments by South African corporations and parastatals.

¶12. Manuel said the government's foreign exchange control amnesty had raised R2.9 billion (\$480,000) in fees and R1.4 billion (\$200,000) in taxes from money previously parked illegally offshore. He identified total assets of R68.6 billion (\$11 billion) from 42,672 applications for amnesty and announced the completion of the amnesty program announced in February 2003. Manuel said that 42,184 amnesty applications were approved, 924 were withdrawn and only 20 applications were declined, with approximately 70% of the disclosed assets illegal. The revenue raised through amnesty fees will be used in public-private partnership investments in community infrastructure and business development in low income areas.

Comment

¶13. Initial reaction to Budget 2006 was mostly positive. Business sector's disappointment stemmed from receiving no reduction in either the corporate or secondary taxes; however, the removal of the RSC levies did yield R7 billion in corporate tax relief, along with reduced administrative burdens of filing RSC paperwork monthly. Community activists and opposition parliamentarians (Democratic Alliance) argued that budget proposals did little for the unemployed and pensioners. Grants to the poor increased in real terms by 2%, although many argue that the bulk of the revenue windfall accrued to those having jobs.

Defending the modest increase in social grants, Manuel warned against 'populist' spending and noted the importance of striking a balance between social assistance and giving people the incentive to work. In addition, he did not think the revenue windfall was sustainable in the future.

¶14. In the face of the March 1 local elections, Budget 2006 emphasized infrastructure spending, improved delivery of services, and targeted tax relief. Most of the tax relief is targeted towards lower and middle income workers, which is not likely to slow consumer demand in the future. By introducing a sharp reduction of taxes on retirement savings, Manuel is hoping to increase South Africa's already low savings rate and shift some of the demand side growth into increased investment. By emphasizing increased investment, Budget 2006 will help South Africa achieve its accelerated growth path. More than ever, South Africa faces a conflict between more redistributive policies shifting out demand at the expense of higher prices or growth initiatives aimed at expanding supply.

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